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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 380

WILLIAM F. SANFORD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. 5a–19a) are reported at 50 T.C. 823. The opinion of the court of appeals (Pet. 1a–3a) is not yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered June 24, 1969. The petition for a writ of certiorari was filed on July 24, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly held that Treasury Regulations requiring a taxpayer to main-

tain documentary evidence in addition to an account book, diary, statement of expense or similar record, to support an entertainment expenditure of $25 or more, are valid and consistent with the requirement of Section 274(d) of the Internal Revenue Code of 1954 that a taxpayer substantiate each element of an entertainment expenditure by adequate records or by sufficient evidence corroborating his own statement.

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of Sections 274 and 7805 of the Internal Revenue Code of 1954 and Section 1.274–5 of Treasury Regulations on Income Tax are set forth in the Appendix, *infra*, pp. 9–17.

STATEMENT

The petitioner, William F. Sanford, during the year involved in this case, 1963, was employed as an outside salesman of television advertising time for RKO General Broadcasting, Inc. (hereinafter referred to as RKO). (Pet. 5a.) Most of petitioner's sales were made through the presentation of recommendations to buy television advertising time, and these "presentations" were often made at luncheons or dinners, either at restaurants or at his home. (Pet. 5a.) Petitioner was reimbursed by RKO for some of these expenditures, generally on the average of $50 to $60 per week, but it was understood that, for the most part, he would have to bear all entertainment expenses above this weekly amount. (Pet. 5a.) Petitioner worked primarily on a commission basis, and his rate of compensation took into account the fact that he

occasionally incurred expenses in obtaining and keeping accounts for which he was not reimbursed. (Pet. 5a–6a.) On his federal income tax return for the year 1963, petitioner listed "outside salesman expenses" totalling $13,950.35, less reimbursement from his employer, RKO, of $4,431.93, and deducted the difference of $9,518.42 as nonreimbursed employee business expenses.

Among the "outside salesman expenses" listed by petitioner was an item for "Entertainment, from my record" in the amount of $8,853.35. Petitioner had been reimbursed by RKO for a portion of these expenses in the amount of $3,186.18, so that his claimed nonreimbursed entertainment expenses came to $5,667.17. (Pet. 6a.)

Of the $5,667.17, the Commissioner allowed $682.86 representing the total of petitioner's alleged nonreimbursed entertainment expenses in individual amounts of less than $25. (Pet. 6a.) He disallowed the balance, $4,984.31, consisting of alleged nonreimbursed entertainment expenses in individual amounts of $25 or more. (Pet. 6a.) It is this disallowance that petitioner disputes.[1]

Petitioner filed a detailed expense account with his employer as to those entertainment expenses for which he sought and obtained reimbursement from his employer. (Pet. 6a.) A number of these expenses were supported by receipts or other documentary evidence, and most ranged from about $10 to $25 each. In addi-

[1] Petitioner did not dispute the disallowance of an additional $815.74 of his claimed employee business expense deduction. (Pet. 6a.)

tion petitioner maintained a desk calendar or "diary" on which he recorded those entertainment expenditures for which he did not seek reimbursement. Most of these expenditures represented the alleged cost of dinners, and most involved amounts in excess of $25. (Pet. 6a–7a.) The entries on the calendar identified the names of the persons entertained, the amount allegedly spent, and, by abbreviation or code, the restaurant, the advertising agency, and the alleged reason for the entertainment. The particular client or account involved in the alleged business discussion was not identified, and in respect of none of the items recorded did petitioner obtain or retain any supporting receipt or other documentary evidence. (Pet. 7a.)

The Tax Court sustained the Commissioner's determination disallowing the alleged entertainment expenditures of $25 or more, and held that Section 1.274–5(c)(2)(iii) of Treasury Regulations on Income Tax requiring documentary evidence to support an expenditure of $25 or more is valid. (Pet. 4a–19a.) The Court of Appeals for the Second Circuit affirmed *per curiam*. (Pet. 1a–3a.)

ARGUMENT

The decision below is correct and there is no conflict or other ground warranting further review.

1. Section 162 of the Internal Revenue Code of 1954 provides for the allowance of a deduction for all ordinary and necessary expenses paid or incurred by a taxpayer during the taxable year in carrying on a trade or business. As a part of the Revenue Act of 1962, P.L. 87–834, 76 Stat. 960, Congress enacted Sec-

tion 274 of the Internal Revenue Code of 1954, Appendix, *infra*, p. 9, in an attempt to curb the widespread abuse in the use by taxpayers of expense accounts, and to require taxpayers to produce more than their unsupported self-serving written or oral testimony to substantiate the deduction of entertainment expenditures as ordinary and necessary business expenses under Section 162 of the Code. H. Rep. No. 1447, 87th Cong., 2d Sess., p. 19 (1962–3 Cum. Bull. 405, 423); S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 24–25 (1962–3 Cum. Bull. 707, 730–731).

Section 274(a)(1)(A) of the Code provides for the disallowance of the deduction of entertainment, amusement, or recreation expenses as ordinary and necessary business expenses unless the taxpayer can establish that such expenses are "directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion * * * that such item was associated with, the active conduct of the taxpayer's trade or business * * *." Section 274(d) of the Code, which we are concerned with here, provides that no deduction shall be allowed with respect to an entertainment activity "unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his own statement" the amount, time and place, and business purpose of the entertainment expense and the business relationship to the taxpayer of the persons entertained. Pursuant to the specific authority given to the Secretary or his delegate in Section 274(h) of the Code, and the Secretary's general regulatory authority contained in Section 7805 of the Code, Appendix *infra*, p. 10, Regu-

lations were promulgated under Section 274 to carry out the Congressional purpose of that section.

Because the term "adequate records" in Section 274(d) is not self-defining, the Commissioner has interpreted it to require the maintenance by the taxpayer of a diary, account book, or similar record, plus, in the case of entertainment expenditures of $25 or more (with exceptions not relevant here), documentary evidence in the form of receipts, paid bills or similar evidence. Treasury Regulations on Income Tax (1954 Code), Sections 1.274–5(c)(2)(i) and 1.274–5(c)(2)(iii), Appendix, *infra*, p. 12. In this interpretation the Commissioner has sought to carry out the Congressional purpose in enacting Section 274 and has achieved a sensible balance by relieving taxpayers of the burden of having to obtain and retain documentary evidence to support entertainment expenditures of less than $25.

Petitioner contends that a diary alone constitutes "adequate records" within the meaning of Section 274(d), and that the Commissioner exceeded his authority in defining "adequate records" as consisting of both a diary and documentary evidence in the case of entertainment expenditures of $25 or more. (Pet. 9.) Petitioner's contention is without merit.

The pertinent Regulations are entirely reasonable. Neither the legislative history nor the purpose for which Section 274(d) was enacted suggests that the authority given the Secretary in Section 274(h) to promulgate Regulations has been abused or exceeded.

Regulations, especially when expressly authorized by the applicable statute, carry a strong presumption of validity. *Farrel-Birmingham Co.* v. *United States,* 121 F. Supp. 636 (Ct. Cl.). This Court has declared that Treasury Regulations must be sustained unless unreasonable and plainly inconsistent with the statute under which they are promulgated. *Commissioner* v. *South Texas Co.,* 333 U.S. 496. The court below thus was correct in its holding that (Pet. 3a):

> Here the disputed Regulation is not inconsistent with the statute, for the phrase "adequate records" is clearly open to interpretation, and the Regulation interprets the phrase so as to carry out the stated congressional purpose of insuring "that no deduction is allowed solely on the basis of his own [the taxpayer's] unsupported self-serving testimony." * * *

Contrary to petitioner's assertion (Pet. 9–11), the Regulations do not require a taxpayer to substantiate entertainment expenses both by "adequate records" and by "sufficient evidence corroborating his own statement" in contravention of the statute which permits substantiation by either of the means specified. If a taxpayer does not have "adequate records" as defined in the Regulations, including documentary evidence where required, he may, in accordance with Section 1.274–5(c)(3), substantiate his expenses without such evidence by "other sufficient evidence"—*e.g.,* the statement or oral testimony of the person entertained. Petitioner's argument rests on the erroneous assumptions that a diary alone constitutes "adequate records", and that documentary evidence is "other sufficient evidence" for purposes of the statute.

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2. It is clear that petitioner failed to substantiate the entertainment expenses here in question by either of the methods prescribed in Section 274(d), and the courts below correctly so found. Petitioner produced only one part of the "adequate records" required by the statute, that of the diary, and even this was found to be inadequate. (Pet. 3a, 10a.) He failed to produce any documentary evidence to support the self-serving statements in his diary. Moreover, he made no attempt to corroborate his diary entries by "other sufficient evidence" as permitted by Section 1.274–5(c)(3) of the Regulations. To allow a deduction in these circumstances would plainly be inconsistent with Section 274(d) and with the Congressional purpose in enacting that provision.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1969.

APPENDIX

Internal Revenue Code of 1954:

SEC. 274 [as added by Sec. 4(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960]. DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES.

(a) *Entertainment, Amusement, or Recreation.*—

(1) *In general.*—No deduction otherwise allowable under this chapter shall be allowed for any item—

(A) *Activity.*—With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

* * * * *

(d) *Substantiation Required.*—No deduction shall be allowed—

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, or

(3) for any expense for gifts,

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating

his own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift. The Secretary or his delegate may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations.

* * * * *

(h) *Regulatory Authority.*—The Secretary or his delegate shall prescribe such regulations as he may deem necessary to carry out the purposes of this section, including regulations prescribing whether subsection (a) or subsection (b) applies in cases where both such subsections would otherwise apply.

[26 U.S.C. 274.]

SEC. 7805. RULES AND REGULATIONS.

(a) *Authorization.*—Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

* * * * *

[26 U.S.C. 7805.]

Treasury Regulations on Income Tax (1954 Code):

§ 1.274–5 *Substantiation requirements.*

(a) *In general.* No deduction shall be allowed for any expenditure with respect to—

* * * * *

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e), or

* * * * *

unless the taxpayer substantiates such expenditure as provided in paragraph (c) of this section. This limitation supersedes with respect to any such expenditure the doctrine of Cohan v. Commissioner (C.C.A. 2d 1930) 39 F.2d 540. The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expense but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction shall be allowed a taxpayer for such expenditures on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term "entertainment" means entertainment, amusement, or recreation, and use of a facility therefor; and the term "expenditure" includes expenses and items (including items such as losses and depreciation).

* * * * *

(c) *Rules for substantiation*—(1) *In general.* A taxpayer must substantiate each element of an expenditure (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement except as otherwise provided in this section. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute clear proof of an expenditure for travel, entertainment, or gifts referred to in section 274. A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient docu-

mentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in subparagraph (2) of this paragraph. To obtain a deduction for an expenditure for travel, entertainment or gifts, a taxpayer must substantiate, in accordance with the provisions of this paragraph, each element of such an expenditure.

(2) *Substantiation by adequate records*—(i) *In general.* To meet the "adequate records" requirements of section 274(d), a taxpayer shall maintain an account book, diary, statement of expense or similar record (as provided in subdivision (ii) of this subparagraph) and documentary evidence (as provided in subdivision (iii) of this subparagraph) which, in combination, are sufficient to establish each element of an expenditure specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, statement of expense or similar record which duplicates information reflected on a receipt so long as such account book and receipt complement each other in an orderly manner.

(ii) *Account book, diary, etc.* An account book, diary, statement of expense or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is made at or near the time of the expenditure.

(a) *Made at or near the time of the expenditure.* For purposes of this section, the phrase "made at or near the time of the expenditure" means the elements of an expenditure are recorded at a time when, in relation to the making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure, such as the amount, time, place and business purpose of the expenditure and business relationship to the taxpayer of any person entertained. An expense account statement which is a transcription of an account book, diary, or similar record prepared or maintained in accordance with the provisions of this subdivision shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice.

(b) *Substantiation of business purpose.* In order to constitute an adequate record of business purpose within the meaning of section 274 (d) and this subparagraph, a written statement of business purpose generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose of an expenditure is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal described in section 274(e)(1), if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explana-

tion of such business purpose will not be required.

(c) *Confidential information.* If any information relating to the elements of an expenditure, such as place, business purpose or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, statement of expense or similar record, provided such information is recorded at or near the time of the expenditure and is elsewhere available to the district director to substantiate such element of the expenditure.

(iii) *Documentary evidence.* Documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure shall be required for—

(a) Any expenditure for lodging while traveling away from home, and

(b) Any other expenditure of $25 or more, except, for transportation charges, documentary evidence will not be required if not readily available.

provided, however, that the Commissioner, in his discretion, may prescribe rules waiving such requirements in circumstances where he determines it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, and, if a charge is made for an item other than meals and beverages, an indication that such is

the case. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.

(iv) *Retention of documentary evidence.* The Commissioner may, in his discretion, prescribe rules under which an employer may dispose of documentary evidence submitted to him by employees who are required to, and do, make an adequate accounting to the employer (within the meaning of paragraph (e)(4) of this section) if the employer maintains adequate accounting procedures with respect to such employees (within the meaning of paragraph (e)(5) of this section).

(v) *Substantial compliance.* If a taxpayer has not fully substantiated a particular element of an expenditure, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements of this subparagraph with respect to the expenditure, the taxpayer may be permitted to establish such element by evidence which the district director shall deem adequate.

(3) *Substantiation by other sufficient evidence.* If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements of subparagraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element—

(i) By his own statement in writing containing specific information in detail as to such element; and

(ii) By other corroborative evidence sufficient to establish such element.

If such element is the description of a gift, or the cost, time, place, or date of an expenditure, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witness setting forth detailed information about such element, or the documentary evidence described in subparagraph (2) of this paragraph. If such element is either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.

(4) *Substantiation in exceptional circumstances.* If a taxpayer establishes that, by reason of the inherent nature of the situation in which an expenditure was made—

(i) He was unable to obtain evidence with respect to an element of the expenditure which conforms fully to the "adequate records" requirements of subparagraph (2) of this paragraph,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the "other sufficient evidence" requirements of subparagraph (3) of this paragraph, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph.

(5) *Loss of records due to circumstances beyond control of taxpayer.* Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as destruction by fire,

flood, earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures.

* * *

[26 C.F.R. 1.274–5.]

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